Ethical issues relating to banking

1. Introduction

In March 2010 the Church Investors Group published a report, *The Ethics of Executive Remuneration*, which showed that executive remuneration, particularly when it was excessive, had a strong moral dimension. This contrasted with the generally accepted view at the time that it was a purely technical subject which formed part of corporate governance.

However it is notable that since the CIG report there has been increased public debate about the social and moral implications of executive remuneration. There seems a strong case for arguing that the banking industry needs to be reminded of the moral basis of its work, based as it is upon trust, and that the Church and Church investors are uniquely placed to do so.

2. Recent ethical scandals

The recent revelation that Barclays and other major banks have rigged the LIBOR rate has resulted in huge controversy and led to the resignation of Barclays' Chief Executive Bob Diamond. However, this is just one among many recent examples where banks are accused of exploiting their power to the detriment of the public good.

2.1 Payment Protection Insurance (PPI)

The UK's large high street banks sold more than 10 million PPI policies to almost half of their personal loan customers, producing an estimated profit of £5bn pa before a ban was introduced in 2009. However, it seems that customers were encouraged to pay high premiums for insurance that was almost worthless. One analyst noted:

> *"Banks were only interested in short-term returns and were paying no attention to whether products were suitable for customers".*

A study by the office of Fair Trading found that claim rates at less than 20% compared with 50% for other kinds of insurance, were low. The FSA has said that the banks have since paid out £3bn in claims, with analysts estimating that there could be further £3bn.

In February 2012 the Financial Services Authority (FSA) informed senior bankers that they had to outline to the FSA how they would reclaim bonuses awarded in previous years to senior executives involved in promoting PPI to the public.

In May 2012 the Lloyds TSB Chief Executive Horta-Osorio described the PPI scandal as 'unacceptable' and cited other mis-sold products, such as mortgage endowments, overdraft charges and interest rate swaps for small business customers, as evidence that the sales culture of banks needed to change. There are some broad ethical issues which include:

2.2 The London Interbank Offered Rate (LIBOR)

LIBOR is of global importance as it is the interest rate that banks pay on money they borrow from one another. It is used as the basis for pricing interest-rate products around the world and ultimately determines the interest rate that is applied to consumer loans such as some mortgages and credit cards, as well as business loans. Indeed, it has been estimated that Libor is used to calculate $800 trillion pa of interest rate and derivative products globally. LIBOR is calculated by reference to interest rate information supplied by 15 of the world's biggest banks, which are under strict obligations to provide accurate figures.

On the 27 June 2012, the FSA and the US Commodity Futures Trading Commission announced that between 2005 and 2009, Barclays traders and managers repeatedly made 'false reports' in order to push LIBOR and other interest rate measures higher or lower than its true rate.

From 2005 until the summer of 2007, Barclays' attempted manipulation was driven by traders trying to increase profits on their own deals using complex financial instruments. From August 2007, in the wake of the credit crunch, regulators found that the senior managements of banks began to direct false reporting activities. During the first years of the crisis, Barclays frequently paid higher interest rates than other banks due to concerns about its financial position. Regulators found that in order to protect Barclays' reputation, the bank's senior management 'routinely' instructed staff to make artificially low LIBOR submissions. Andrew Tyrie, the chairman of the Commons Treasury select committee, said Barclays had put at risk the integrity of the financial markets, with potentially serious consequences for British consumers:

> *"This is tantamount to lying. This could have affected hundreds of thousands of homeowners by forcing them to pay more for their mortgages."*

Barclays was fined a record £290 million for repeatedly distorting basic financial data. However the regulators warned that with up to 40 global banks facing investigation, other major British banks may also have been involved in attempts to manipulate data about interest rates.

2.3 Interest rate hedges

On the 29 June 2012 the FSA announced it had it found 'serious failings' in the way the major high street banks, Barclays, HSBC, Lloyds Banking Group and Royal Bank of Scotland, had sold complex financial products to around 28,000 small and medium sized businesses. These were interest rate swaps, allegedly designed to protect customers from interest rate rises. The FSA said that a two-month review had uncovered widespread evidence of mis-selling by banks, which it believed had had a 'severe impact' on some small businesses and that it expected banks to provide 'appropriate redress'.

There were two areas of concern about the products: first, their great complexity, which made it extremely difficult for small businessmen to understand them; second, allegations that in some cases banks made the availability of finance conditional upon their clients taking out such a product. There were widespread reports that some customers had been left with hundreds of thousands and even millions of pounds in costs they say they were never warned about.

3. Public condemnation

These scandals have led to a growing view that there is something fundamentally wrong with the industry. In a recent speech Mervyn King, Governor of the Bank of England said:

> *"It goes to both the culture and the structure of the banking industry, from excessive levels of compensation, the shoddy treatment of customers, to the deceitful manipulation of one of the most important interest rates, and now this morning to news of yet another mis-selling scandal. We can see that we need a real change in the culture of the industry"*

Financial Times banking commentator Philip Augar wrote:

> *"The industry has to be serious about cultural change. This means reforms on pay to remove the grotesque incentives that encourage corrupt behaviour, and the introduction of an ethical code consistent with the business model. There is no point telling staff the client comes first and then rewarding them on the profit they make for the firm. Senior managers must make it clear the institution's first responsibility is to the integrity of the market and the interests of the client. Corporate profit and individual compensation is the outcome of such behaviour not its motor."*

On his retirement in April 2012, Chief Executive of the FSA Hector Sants stated:

> *"The crisis exposed significant shortcomings in the governance and risk management of firms and the culture and ethics that underpin them. This is not principally a structural issue. It is a failure in behaviour, attitude and, in some cases, competence."*

4. Other ethical issues

4.1 Executive remuneration

This year there has been growing concern about executive pay in general and the banking sector in particular. In May 2012 Martin Taylor, a former Chief Executive of Barclays Bank and a member of the Independent Commission on Banking welcomed the growing number of shareholder revolts:

> *"By failing to handle a business problem at the proper time, the boards of banks have managed to turn it into a wider social issue that is resonating well beyond the banking industry. It is easy to forget, in the general atmosphere or moral indignation, what a serious economic issue bank pay had become. The industry's contention, that it concerned nothing more than the distribution of profits earned in an open, competitive market, was always questionable. It was the search for higher remuneration pools that led banks to expand their balance sheets, running risks with results from which we have all suffered."*

Taylor argued that the '*pursuit of risk in pursuit of pay'* had led to banks taking increasing risks with their capital which had been a contributing factor of the 2008 financial crisis and was an issue for governments given the implicit taxpayer guarantees for banks. He also argued that excessive pay throughout the banking system had damaged social cohesion as well as ultimately pushing up costs for customers:

> *''Something has to give in the cost structure, and that something is pay. The recent shareholder meetings resemble a dialogue of the deaf. The banks point out that they have made fundamental changes and that pay for many has fallen in a relatively poor year. But this is to miss the point, which is that pay levels are in absolute terms too high by something like a factor of three.'….Executive pay has been inflated all round by the excesses of the banks. But for most industrial companies, pay structures still largely follow the hierarchical pyramid; high earners are few; the economic issue is marginal."*

4.2 Lobbying

As a result of the financial crisis regulators in many countries announced plans to reform the banking industry. There was widespread concern that a government's need to protect the 'utility' function of transferring money around the economy was supporting own-account investment banking, sometimes known as 'casino banking'. In June 2010 the UK Treasury announced the creation of the Independent Commission on Banking led by Sir John Vickers. This advocated 'ring-fencing' retail banking from investment banking by 2019, although detailed regulatory proposals are still awaited.

Ironically, in the US after the Great Crash of 1929 the US Congress passed the 1933 Glass-Steagall Act prohibiting the combination of commercial and investment banking. This was repealed by President Clinton in 1999, which is widely believed to have contributed to the US credit boom and subsequent bust in the following decade. Following the 2007-2008 financial crisis, the US Congress passed the Volcker Rule, drawn up by former Federal Reserve Chairman Paul Volcker, banning commercial banks from trading on their own account, known as 'proprietary trading'.

While these are structural and regulatory issues, there is concern that the banking industry has engaged in intense political lobbying to water down regulatory proposals both in the UK and US. In the US the head of JP Morgan, Jamie Dimon was an outspoken critic of the Volcker Rule. However, he was recently obliged to announce that the bank had lost at least $2bn in derivatives trading, with the loss now currently estimated to be at least $5bn.

4.3 Financial exclusion

In March 2011 ECCR published a report, *The Banks and Society: Rebuilding Trust*. This noted that the business models of banks exclude some individuals and business from accessing financial services, especially in disadvantaged areas. Financial exclusion is believed to aggravate social and other inequalities, with those particularly vulnerable including: young people not in employment; lone parents; people with disabilities or mental health problems; carers; and older people. This trend has worsened with an estimated 43% reduction in UK bank branches since 1990, leaving people in rural and poor urban areas without a bank.

In 2005 the government persuaded the British Bankers' Association to develop *basic bank accounts*, designed to be more accessible and manageable than standard current accounts. However, there is little evidence that these have been promoted by the banks.

4.4 Customer service

Although the banks claim to aim at good customer service, the evidence suggests the contrary. The FSA publishes the number of complaints received by banks in each six month period, with Lloyds TSB and Barclays coming out particularly badly. In 2010 the FSA reviewed the complaint procedures of six banks. It found that:

> *"Most of the banks assessed had not embedded a culture that focused on delivering fair outcomes for complainants. This resulted from a lack of management engagement, poor procedures, and poor staff incentive schemes."*

4.5 Complexity

There are also widespread complaints about the complexity of retail banking arrangements. Many critics argue that the current system of 'free banking', with no charge for operating current accounts, is unjust as they are effectively a loss leader, with the banks recouping costs through fees such as penalty charges on overdrafts and bounced cheques. Both the FSA and the Council of Credit Unions have suggested that free current accounts also limit competition by making it difficult for small organisations such as credit unions to compete.

4.6 Responsible Lending

In the US the term 'predatory lending' is defined by the government as: 'imposing unfair and abusive loan terms on borrowers'. While the term is not formally in use in the UK, it seems a useful term to describe behaviour where loans are offered in such a way that is clearly not in the best interests of the borrower. In the UK the Office of Fair Trading has issued *Guidelines on Responsible Lending* which states that lenders should:

- Not use misleading or oppressive behaviour when advertising or selling credit agreements;
- Make a reasonable assessment of whether a borrower can afford to meet repayments;
- Explain credit agreements so that borrowers can make an informed choice;
- Ensure that documentation is not misleading, and that terms and conditions are transparent and not unfairly balanced in favour of the lender.

4.7 Tax Avoidance

There is increasing public concern about the way rich individuals have been using tax avoidance schemes to minimise payment of tax. The large UK banks, particularly Barclays, are believed to have made large profits marketing sophisticated tax avoidance schemes. Indeed, Barclays' structured capital markets division has marketed tax arbitrage schemes to rich clients around the world and some that have been sold in the US and Italy are subject to legal dispute.

5. Key ethical considerations for banks

Traditional Christian teaching on social justice implies that as Church Investors we cannot ignore the recent banking scandals and the way they have oppressed the poor. Some issues are best left to those within the churches whose task is to lobby governments for changes in the law and public policy. However, the task for Church investors is to focus on seeking a change in the corporate ethos of financial institutions working towards the end of the type of inappropriate behaviour recently witnessed.

6. Advocacy issues

Advocacy for industry wide changes would seem an appropriate activity for the public issues and social responsibility arms of the churches.

6.1 Separation of Investment Banking and Commercial Banking

It is arguable that without a clear separation of investment and commercial banking attempts to reform the banking sector will be ineffective. The Vickers Commission advocated ‘ring-fencing’ the two. However, there are increasing calls for a formal separation of the two functions. For example an editorial in the *Financial Times* on 3rd July 2012 argued for this along the lines of the old Glass-Steagall Act.

> *“The hard-charging revenue seeking investment banking culture predominates whenever they are put together (with commercial banking). The more herbivorous retail banking ethos – with its emphasis on patient stewardship – is marginalised. This seems to lead ineluctably to the proliferation of socially questionable trading activities and abuses such as the LIBOR scandal.”*

The *Financial Times* echoes other criticisms of the current universal banking model in that it:

- Encourages high risk speculation that is effectively underwritten by the tax payer. If the trades pay-off, the traders and management are rewarded with very high remuneration, but if they lead the bank into trouble, the government feels obliged to step in to protect the commercial and retail activities.
- Has resulted in the corporate banking culture being corrupted, departing from a prudential low-risk approach to a more aggressive risk-taking one, with staff incentive schemes changing accordingly.

6.2 Transparency

It seems obvious that banks need to be more transparent. For example, the products they sell should clearly state the fees charged and the risks involved. It would also be helpful if there was greater disclosure over the source of profits. If they are unwilling to voluntarily disclose such information it may be appropriate for the churches to lobby for legislation.

6.3 Penalties

If current penalties, whether financial or other sanctions including custody, are considered ineffective, lobbying for heavier sanctions may be considered.

6.4 Leverage

Banks have proved to lack prudence in setting appropriate levels of gearing. Lobbying for legislation to limit further the gearing of banks may be appropriate.

6.5 Retail and Business Lending

Seek requirements (eg Project Merlin) in relation to facilitating the everyday financial activities of businesses and individuals. This would be the quid pro quo for the continuation of the implied state guarantee of the ‘utility’ aspect of banking.

6.6 Independent commission on banking

Lobbying for implementing fully the recommendations of the Independent Commission on Banking.

7. Responsible investment issues

The following would seem to be legitimate issues for Church investors to address when establishing ethical policies relating to banking; guiding corporate engagement in the sector and in extreme cases disinvestment and exclusion on ethical grounds of some organisations.

7.1 Stewardship

The essence of commercial banking is to move large amounts of money accurately and safely around the economy. Retaining the trust of the public is a key part of this. If commercial banks explicitly adopted the concept of 'stewardship', and put in place management structures to achieve this, it would reassure the public and should result in retail banking returning to its traditional ethos.

7.2 Transparency, disclosure and education

Although it may be appropriate to lobby for legislation in relation to banking, as investors we may have an obligation to encourage greater voluntary transparency through our engagement strategies (see 6.2 above).

Similarly, we could encourage better voluntary operating principles to provide customers greater protection from being pressured to buy products they don't need.

Another possibility would be to encourage work with schools and other educational institutes to help increase financial literacy among bank customers.

7.3 Management and incentives

If commercial banking were separated from investment banking it would probably be easier to introduce management incentive schemes based upon a 'stewardship' approach. Staff assessment needs to be based more on customer satisfaction and the avoidance of complaints, rather than, for example, the reckless pursuit of sales targets that destroyed HBOS.

This would also need to be incorporated in the design of executive remuneration policies. For example, a manager whose branch received repeated complaints would find this reflected adversely in her/his annual review and salary. HSBC has recently introduced a new senior staff incentive scheme which rules out long-term cash bonus, and pays staff in shares in the company. These cannot be sold until the employee leaves the company, and are subject to claw-back if later information comes to light on poor performance. Such an approach seems well suited to the long-term, cautious nature of retail banking.

7.4 Whistle-blowing and ethical reporting

All banks have codes of ethics, but the wealth of recent scandals suggests that this is little more than box-ticking. The banks need to introduce measures to ensure that ethical behaviour is followed. In many of the recent scandals there have been reports that junior management complained about what was happening, but were ignored by senior executives.

Consideration could be given to the introduction of a senior ethics officer, reporting directly to the Board, who would have responsibility for monitoring all ethical questions arising from staff.

7.5 Financial exclusion

The commercial banks should do more to help fight financial exclusion. They could promote basic banks accounts more actively, and investigate other means of greater financial inclusion, such as mobile banks.

7.6 Lobbying

Banks should fully disclosure their lobbying activities, which are after all a use of shareholders' funds.

7.7 Tax Avoidance

Banks should be transparent about their own measures to minimise tax. They should also spell out all revenues and profits derived from facilitating tax avoidance.